

Management Discussion and Analysis

Overview

Although we are not required to file a financial report with the Securities and Exchange Commission (SEC), we include a Management Discussion and Analysis (MD&A), an SEC requirement, in our annual report. According to SEC regulations, the MD&A should give the reader “an opportunity to look at the company through the eyes of management by providing a short- and long-term analysis of the business of the company.” In our discussion, we have attempted to comply with the latest SEC guidance for an MD&A written in plain language.

Our MD&A contains two major topics: Operations, and Liquidity and Capital. In Operations, we discuss Income, Revenues, Expenses and Other Issues. In the Income section, we discuss our net income and the sources and amounts of our contributions by our core classes of mail. With net income of \$550 million we had an outstanding year in 1998. This followed our successes of almost \$1.3 billion in 1997 and nearly \$1.6 billion in 1996. In relation to our net income, we discuss the rate-setting process that Congress has established, a process that exercises significant control over our revenues. We also discuss equity restoration. Finally, in this section we discuss our Economic Value Added (EVA) program, which is a tool that we use to measure and manage our financial performance, allowing us to become more efficient in everything we do.

In the Revenue section, we discuss our revenue by our core classes of mail. Three products—First-Class Mail, Priority Mail and Standard Mail (A)—account for over 90 percent of our volume and contribution. Revenue from First-Class Mail grew 1.8 percent, 7.6 percent from Priority Mail and 6.8 percent from Standard Mail (A) in 1998 compared with 1997.

In the Expenses section we discuss the two operating expense categories—personnel Compensation and Benefits, and Transportation—that make up almost 84 percent of our total expenses. During 1998 we controlled these costs and held them to an increase of 4.0 percent. Even though our workload increased and we have improved our service, personnel compensation and benefits increased by 4.0 percent compared with only 2.7 percent over 1996. Both an increase in the amount of transportation and in the cost of transportation caused transportation expenses to increase 4.5 percent.

Finally, in the Other Issues section we discuss those issues that we think may significantly affect our financial condition. We discuss our service to the community with our Breast Cancer Research semipostal stamp, recent legislative activity including proposed postal reform, Postal Service productivity, the effects of classification reform, environmental matters, *CustomerPerfect!*, our Year 2000 preparations and inflation.

In Liquidity and Capital, we discuss our liquidity management program. We discuss our efforts to reduce the number of banks we use. In addition to managing our liquidity better, we have reduced our interest on debt almost 55 percent since 1996. And we have increased the flexibility of our debt portfolio, obtaining \$10 billion in additional notes that we can borrow against with short notice from the Department of the Treasury, thus making borrowing easier and more economical. We also discuss our capital investment program. Under this program we will invest \$17 billion in capital projects over the next five years designed to improve customer service while helping us operate more efficiently and economically.

OUTLOOK

While you review our Management Discussion and Analysis, you will find it helpful to understand how we see the future of correspondence and the mail business. Providing mail services is a mature but growing business. Despite the fact that since 1832 the Postal Service and its predecessor the Post Office Department have lost market share, postal revenues have grown at the same average rate as the gross domestic product. We project total mail volume over the next decade will grow 3 to 4 percent a year, with First-Class Mail growing 1 to 2 percent a year. Many factors outside of our control such as population growth, competition, technological change, economic activity, residential demographic patterns, and the increasing value of people's time affect the growth in mail volume.

We know that we control our future by improving our service performance, keeping our costs down and our prices competitive. During the last seven years, postal prices have fallen in real terms, and our strategy is to continue to keep postal price increases below inflation over the next decade. Declining real postage prices contribute to increasing mail volume. Thus, our management incentives reward behavior that leads to declining real prices. Another way is to make large capital investments in technology to further automate how we do business, thus improving productivity

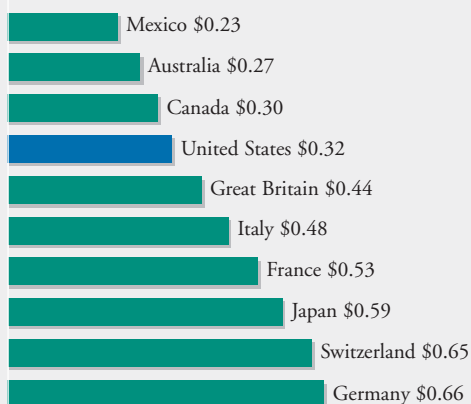


“The Postal Service has an enormous impact on this country, be it the economy or the community. Every two weeks, we inject approximately \$1.6 billion into the economy in the form of salary and benefits to our employees. It’s those employees who deliver hope in their communities by participating in food drives, becoming marrow donors, or reaching out to help in times of need.”

Michael S. Coughlin
Deputy Postmaster General

GLOBAL BARGAIN

comparative value of a First-Class stamp as of September 30, 1998



and making us more efficient while improving our service.

The adult population (as measured by persons 22 years old or older) rose 50 percent from 1970 to 1995. During this same time, mail volume rose 113 percent. Since studies predict that the U.S. population will grow between 0.9 and 1.0 percent a year over the next decade, we believe our fundamental business will remain dynamic and that the Postal Service will continue to be the largest mail service organization in the world. For the short term, we expect modest growth in our overall markets. However, we also expect that our competitors will further erode our market, especially since they are not bound by the same regulatory restrictions and governmental mandates that bind us. These competitors are free to target profitable customers and sectors of the market while avoiding others. We, however, are required to serve everyone at the same price.

Technology will continue to put competitive pressure on our correspondence and transaction mail volume. Bills, statements and remittances (payments) represent \$13 to \$16 billion of revenue, with a very large contribution towards covering costs and net income. We monitor developments in this market very closely. We do not forecast a precipitous short-term revenue loss to alternative technologies such as electronic mail and bill paying. However, we know that for the long term such technologies present a serious threat.

Technology has also created opportunities. The increasingly sophisticated use of data allows businesses to go beyond using the mail as a targeted advertising medium to a personalized means of building lasting business relationships. Declining computing costs along with rapid innovation in

Considering our volume
and the geographic area
and population we serve,
we are a global bargain.

database management and demographic analysis contributed to a rapid growth in mail volume in the 1980s. These developments, combined with the introduction of work-sharing discounts, which helped mailers take economic advantage of these trends, caused an explosion in mail volume.

Although providing postal services is not highly cyclical, economic activity does affect the demand for postal services. Current projections based on historical trends of the U.S. economy predict a steady expansion between 1998 and 2008. The basis for these projections is an average increase of 2 to 3 percent annually in the gross domestic product through 2008. While we would do better if the very strong economic trends of the last four years were to continue, our current operating assumptions are based on an economy that grows more slowly in 1999 than it has during the last four years.

We are monitoring the economy very carefully, because there are significant areas of concern. Starting with the June 1997 collapse of the Thai baht, there have been continuing currency crises in the emerging market economies, which have caused economies representing over 40 percent of global gross product to be in a recession or a depression. U.S. exports have dropped 10 to 15 percent. Loan losses abroad have reduced the lending ability of major banks, and their impaired capital could cause a credit crunch. This situation has caused us concern because the financial sector is important to the mail. The continued strength of the U.S. economy in 1998 was built on strong spending by consumers. This growth may be reaching its limits. A disappointing holiday season for retail purchases in 1998 could cause advertisers to rein in future expenditures.

Our discussion in the MD&A represents our best estimate of the trends we know about, the trends we anticipate, and the trends that we think are relevant to our future operations. However, actual results may be different from our estimates.



**10,500 miles
for just 32¢**

You can send a letter the
10,500 miles from Bangor,
Maine, to Koror, Palau,
for just 32 cents.
That's 32 millionths
of one cent per mile.

Income

In this section we discuss our net income for 1998 and explain the concepts of product contribution and volume-variable costs. We also discuss the rate-making process that determines our rate structure. (Please note that our approved rate increase is discussed in the Other Issues section.) And we discuss the progress of equity restoration, which we include in our rate structure. Finally, we discuss our Economic Value Added program, which we believe is helping us manage our resources better by changing employee behavior.

Our income depends on the rates we are allowed to charge, on the volume of mail we handle, and on our expenses. For a further discussion of the changes in our mail volume, see the Revenue section. For more details on our expenses, see the Expenses section.

NET INCOME AND CONTRIBUTION

Because we have not had a general price increase since early 1995, we consider this year's net income of \$550 million to be a continuation of our financial successes of over a billion dollars of net income in each of the prior three years. This year's net income plus the nearly \$1.3 billion in 1997 and almost \$1.6 billion in 1996, gives us a three-year net income of almost \$3.4 billion. This success is especially noteworthy because it is the first time that we have had four consecutive years of positive bottom line results.

Governor Winters noted this success in announcing a delay in implementation of new rates by saying, "This success has allowed us to return a dividend to the American public by extending stable rates for a full four years." The dividend is theoretically based upon the increase to our net income that would certainly have occurred had the Board of Governors implemented the general price increase at the same time they approved it in July of 1998. However, citing continued record delivery service and financial performance success, the Board chose to delay the rate increase for six months. The proposal to raise rates, Winters added, always has been about maintaining a solid, strong and universal Postal Service. "The rate adjustment is being made to provide a continuing investment in America's communications future. We need to continue investing in those things that will improve consistency in home delivery and improve and innovate services for American businesses."



"From the workroom floor to the front door of every customer, the Postal Service's greatest asset is the employees who make it all happen. In 1998, the men and women of the Postal Service processed 198 billion pieces of mail through our system, carrying on a tradition of delivering value. No other mail system in the world can match the efficiency or devotion of our employees."

John E. Potter
Senior Vice President,
Labor Relations

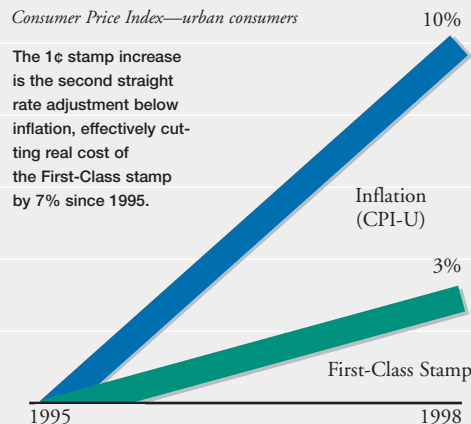
Our bottom line results are due to a combination of factors affecting our revenue and expenses. Operating revenue for 1998 increased almost \$1.9 billion compared with 1997, an increase just slightly more than the \$1.8 billion increase of 1997 over 1996. However, our 1998 increase in revenue did not offset our \$2.9 billion increase in operating expense. This increase in expense was significantly more than the \$1.8 billion increase of 1997 over 1996. Key factors in our growth in operating expenses were an increase of \$1.8 billion in compensation and benefits in 1998, including a \$554 million increase in workers' compensation expense, an increase resulting, in large part, from an upswing in the average cost per medical claim.

To put this year in perspective, our last general rate increase of January 1995 came after four years without an increase. Even then the increase was relatively small at only 10.3 percent. Between 1972 and 1998, the price of a postage stamp rose at only slightly more than prices in general, going up, on average, by about 5.5 percent per year, compared with an inflation rate averaging 5.3 percent, as measured by the Consumer Price Index for urban consumers (CPI-U). In fact, over the past seven years, the price of a stamp climbed significantly more slowly than prices as a whole, going up by only 2.1 percent per year, compared with an inflation rate of 2.7 percent annually.

We have prepared the chart on page 35 to illustrate the estimated 1998 contribution from various classes of mail. Contribution is the difference between revenue and volume-variable costs. As the term implies, volume-variable costs are those costs that vary directly or indirectly with

RATE OF INFLATION

Consumer Price Index—urban consumers



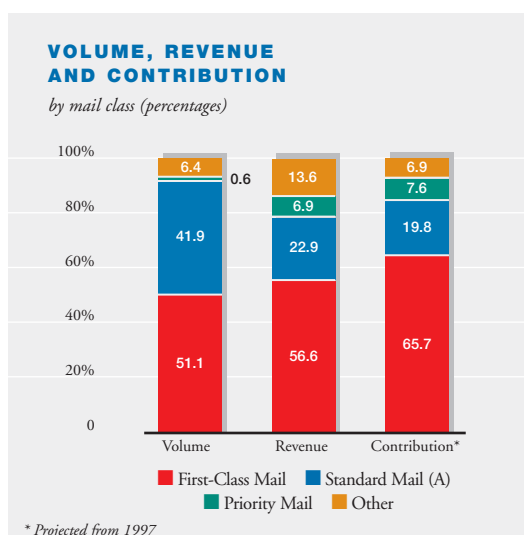
changes in mail volume. For example, a high percentage of mail processing costs are considered volume-variable costs since changes in mail volume directly affect the number of hours clerks and mail handlers have to work. On the other hand, only a small fraction of postmaster salaries are considered volume-variable costs since these costs are, for the most part, unaffected by changes in mail volume. In 1997, volume-variable costs totaled \$32.2 billion, or about 56 percent of total costs. The remaining \$24.8 billion of costs are nonvolume-variable and must be borne, ultimately, by the combined revenues of all classes of mail. When we say that First-Class Mail “contributes” \$17.0 billion, for example, we mean that the postage collected from First-Class Mail exceeds the volume-variable cost of First-Class Mail by \$17.0 billion.

Most of our product lines had modest volume increases in 1998. While we have introduced various new products to diversify our product base, their impact is minimal in relation to our core products. Our main core product, First-Class Mail, accounted for approximately 51 percent of our volume, 57 percent of our revenue and 66 percent of our contribution. Priority Mail accounted for less than 1 percent of our volume, almost 7 percent of our revenue and 8 percent of our contribution. Our bulk business mailers accounted for almost 42 percent of our volume, but only 23 percent of our revenue and 20 percent of our contribution. These three products combined to provide almost 94 percent of our volume and contribution. While we will continue to expand our opportunities for revenue growth, we focus on what we do best, which is our core business. We believe that our future success depends on an emphasis on personal accountability, service, effective use of resources, and product contribution.

The Volume, Revenue, and Contribution chart shows contribution by class of mail. Together, First-Class Mail, Priority Mail, and Standard Mail (A) represent 93 percent of the total contribution. Half of our First-Class Mail contribution comes from single-piece mail.

RATE SETTING PROCESS

Until 1971, Congress set postage rates by law, with no relationship between the revenue from those rates and the actual cost of operating the postal system. Since 1971, however, the Postal Reorganization Act has required the Postal Service to establish postal rates that cover the costs of operating the postal system. To achieve this alignment of rates with expenses, the Act established a rate-making process that allows rates to be adjusted as necessary.



The rate-making process begins when management projects that current rates will not be adequate to meet our mandate of “covering costs” in the future. The Postal Service, upon concurrence with the Board of Governors, submits a request for a recommended decision on rate and fee changes to the Postal Rate Commission. (Like the Postal Service, the Commission is an independent establishment of the executive branch of the government.) As allowed by law, the Postal Service submits its request accompanied by detailed rate proposals supported by extensive testimony and documentation.

The Commission holds public hearings, allowing such interested parties as mailers, competitors, and consumer advocate groups to question the Postal Service’s proposals and submit their own testimony and proposals. At the conclusion of the hearings, the Commission sends its recommended decision to the Governors. The Governors may approve, reject, allow under protest, or, under certain limited circumstances, modify the Commission’s recommendations.

Although the Postal Reorganization Act requires the Commission to issue its recommended decision within ten months of the filing of the Postal Service’s request, the entire process—starting with preparing the necessary documentation to support the rate proposals and ending with implementing the new rates—takes approximately 16 to 18 months. While this rate-making process has allowed us to bring revenues more in line with costs, this process offers us only limited flexibility in responding quickly to changes in our costs and in the markets in which we compete.

41%

We deliver 41 percent of the world’s mail. The next largest is Japan, with 6 percent.

PRIOR YEARS' LOSS RECOVERY

By law, our rate-making process must produce revenue that at least covers our expenses. This means we must set rates to approximately break even.

We should have maintained an equity balance transferred to us from the United States government when we were established in 1971. This equity balance plus subsequent capital contributions is approximately \$3 billion. From 1971 to 1994 we did not maintain revenues equal to our expenses, and therefore, we did not maintain the \$3 billion equity balance that was transferred to us. Indeed, by the end of 1994 we had almost \$9 billion in cumulative net losses, making our net equity deficiency approximately \$6 billion.

To understand why we must restore equity is to understand that equity is an important representation of a company's financial health. While private companies operate with negative equity only in unusual circumstances, government agencies often do so because they provide services without receiving any fees for those services. However, Congress gave the Postal Service a unique mandate. We must act like a business and, by law, our revenues must cover our costs. So, for us, equity is a measure of our financial health just as it is for private companies. In order to return the Postal Service to financial health, the Board of Governors adopted a resolution in July 1995 affirming our commitment to restore equity by recouping the losses we accumulated from 1972 to 1994. Beginning with the 1995 rate increase, \$936 million per year is included in our rates so we can return to financial health. This recovery amount has been reduced to \$377 million in the postal rate increase scheduled for January 1999.

ECONOMIC VALUE ADDED

Economic Value Added (EVA) is the measure we use to set our financial goals, determine whether a business strategy makes financial sense, evaluate our total financial performance, and reward employees by tying compensation to measurable performance. The EVA program, now in its third year, appears to be achieving the desired results: control costs and improve service.

In 1998 we began to index our EVA calculation, using 1997 as the base year. After determining net operating income, as defined for EVA purposes, and

subtracting a charge for the capital we use to produce that income, we applied an indexing factor. The indexing factor removes the impact of postal price increases and inflation, giving us a true year-to-year comparison of our operating performance. Further, indexing eliminates the link between pay incentives and rate increases. It rewards postal employees for keeping rate increases below the rate of inflation.

Because EVA is a measure of operating results, it excludes financing costs such as interest and any unusual or nonrecurring transactions that are not part of the normal course of business. As a comprehensive financial measure, EVA gives us a single number representing both our operating results and how efficiently we use our assets. By measuring how efficiently we use our resources, we can determine how much value we have added to our business from one year to the next.

EVA emphasizes managing the business and creating value. It focuses our attention on increasing and improving our business, so that we produce long-term value by using our capital assets efficiently.

The total Economic Value Added from 1996 through 1998 is more than \$2.4 billion.

A key to achieving continuous improvement is linking compensation with results. An integral part of our EVA system is an incentive payment system that rewards people for financial performance (as measured by EVA), customer service, and employee commitment. These incentives are tied directly to the EVA we generate. Creating EVA involves the efforts of each and every employee contributing to our financial and operating performance. We encourage our employees to find ways to reduce waste, control inventories and expenses, increase revenues, and operate equipment efficiently.

Our mission is to be a customer-driven business with products that provide the best value in the postal communications market. We think EVA is an important means for achieving that goal.



**2,300 trips
to the moon
and back**

NASA made six manned trips to the moon. Every year we drive 1.1 billion miles to move the mail. That's equivalent to 2,300 trips to the moon and back.

**ANALYSIS OF
OPERATING REVENUE**

(dollars in billions)

	1998	1997	1996
First-Class Mail	\$33.98	\$33.40	\$33.12
Standard Mail (A)	13.75	12.88	12.18
Priority Mail	4.15	3.86	3.32
Standard Mail (B)	1.63	1.63	1.52
International Mail	1.60	1.61	1.65
Other	4.96	4.84	4.61
Total operating revenue	\$60.07	\$58.22	\$56.40

Revenue

In this section we present our revenue results for 1998, compare these results with 1997 and 1996 and discuss trends that we believe to be important. These trends represent our best judgments, actual results may vary from our estimates.

GENERAL

America is peculiar among the world's nations because it has a large and increasing portion of its population clustered in demographically homogeneous residential centers. This concentration, combined with population mobility, makes it difficult for broad-based advertising media to target specific audiences. Thus, the mail is the premium medium for targeting specific audiences, giving it a competitive advantage. Moreover, we think that the baby boomer population will continue to be the major economic force in the mail services we deliver. According to the Household Diary Study, First-Class Mail peaks in the 45-64 age group and Standard Mail (A) in the 65-69 age group. We think that as these age groups increase and as they reach their maximum earning power, they are more likely to use traditional mail services, while the younger population may be more likely to switch to alternative postal services.

Reinforcing these demographic patterns is the increasing value of people's time. To the extent that the mail can help consumers shop from home and save time, we see further opportunity for growth in our services. And, as businesses strive to reduce labor costs, we see the mail offering an inexpensive way to build relationships while replacing expensive face-to-face communication.

OPERATING REVENUES

Our operating revenues for 1998 maintained the same level of growth as the increase from 1996 to 1997. At \$60.1 billion, 1998 Operating Revenue was up 3.2 percent. First-Class Mail, which constitutes our largest revenue and volume category, grew 1.8 percent in revenue on a 1.5 percent growth in volume. Standard Mail (A) revenue increased 6.8 percent on a 7.3 percent increase in volume. Revenue for Priority Mail increased 7.6 percent on a 9.0 percent increase in volume, while revenue gains in our other classes of mail were more modest. We expect volume to continue to grow in 1999, with revenues growing proportionally in most classes of mail. Overall, for 1999 we expect revenue to grow approximately 4.9 percent, with Priority Mail and

Standard Mail (A) leading that growth. This growth will track volume increases, expected to put us over 200 billion pieces of mail in 1999 and to a lesser extent our rate increases.

We get over 60 percent of our mail through our bulk mail entry units, so we can identify this revenue according to classes of mail. For most other mail, we use a sophisticated sampling system that allocates the revenue from this mail to classes. However, this process is not available in final audited form until after our year end.

During the year, we use a number of sources of data to update the models that estimate our revenue by class of mail, the number of pieces of mail we handle, and the weight of the mail. Some of our analysis and data in this section comes from those models.

CLASSES OF MAIL

We offer a variety of products to meet our customers' needs. Our primary products, based on percentage of total revenue, are First-Class Mail (56.6%), Standard Mail (A) (22.9%), and Priority Mail (6.9%), which combine to make up over 86 percent of our total revenue, which is approximately the same percentage as 1997 and 1996. With these classes we can offer our customers a unique bundle of services that enable them to choose the service and price that best suits their needs. We discuss each of these classes of mail below.

First-Class Mail

First-Class Mail, which includes personal correspondence, post cards, small parcels, and business transactions, is a mature product which had volume growth of 1.5 percent and revenue growth of 1.8 percent in 1998. While the increase in revenue was in line with what we had projected, the increase in volume was less. The less-than-expected volume growth was largely due to the decline in single piece mail volume. This decline was partly offset by the growth in the Presort category. Presort letters and flats make up 40 percent of the First-Class volume and have had an average growth rate of 4.9 percent per year since 1995. We believe that the slowdown in volume growth was due to two factors: the Classification Reform of 1996 and the electronic diversion of mail.

In 1996, we changed our mail classification structure. (Classification is the rules and regulations that specify what type of mail can be sent in a particular class.) As a result of the changes in the classification structure, mailers were able to use lower cost classes of mail. While we expected mailers



"Our customers, large and small, look to the Postal Service as a trusted third party to meet their individual mailing needs. We are improving our products and services so that whether it's making sure millions of catalogs arrive in time for a big sale or that a loved one receives a birthday card on time, we continue delivering on our promise every day."

Allen R. Kane
Chief Marketing Officer &
Senior Vice President

to take advantage of these changes to shift their mail within and between classes of mail, we did not know exactly how much our mail volume in each of the classifications would change.

The effects of classification reform continue, with a substantial shift in the volume of certain categories of First-Class Mail. There has also been a change in the relative growth rates between First-Class and Standard Mail (A), resulting in a lower growth in the volume and revenue of First-Class Mail, and a higher growth in the volume and revenue of Standard Mail (A). In 1997, First-Class Mail volume grew 1.5 percent, while revenue grew 0.8 percent. In 1998, volume grew 1.5 percent, continuing the trend of smaller than expected volume growth. Revenue grew 1.8 percent, up slightly from 1997.

In addition to the effects of classification reform, we believe that the expanding use of electronic media will also affect the growth in volume and revenue of First-Class Mail. While it is difficult to determine exactly how much First-Class Mail has been lost to electronic mail, automated transfer of funds, electronic data interchange, automated bill payments, and facsimiles, it is clear that some mail has been lost to these alternatives. The use of these alternatives will continue to affect the growth in the volume of First-Class Mail. For example, the United States Treasury will soon require that approximately 7 million companies pay their business taxes electronically, resulting in 160 million electronic transfers. In addition, both the federal government and most state governments have plans to make benefit payments by electronic transfer and not by check. We expect to lose significant First-Class Mail revenues as a result of such changes.

On a per-piece basis, First-Class Mail costs have shown little change in recent years and actually declined nearly 2 percent from 1996 through 1997 from 16.7 cents to 16.4 cents. This decline occurred in spite of an increased focus on First-Class Mail service performance. Although 1998 costs by class of mail are not available at this time, First-Class Mail unit cost growth is expected to remain moderate.

Standard Mail (A)

Standard Mail (A) includes advertising letters, flats and small parcels. Standard Mail (A) is predominantly presorted mail. Because Standard Mail (A) typically is substantially less expensive per piece than First-Class or Priority Mail, it is used by mailers whose primary concern is the cost of mailing. In order to use this class of mail, mailers must meet specific volume and content requirements. Presorted Standard Mail (A), or bulk mail, as it is often called,

ANALYSIS OF MAIL VOLUME

(pieces in billions)

	1998	1997	1996
First-Class Mail	101.17	99.66	98.22
Standard Mail (A)	82.87	77.25	71.69
Priority Mail	1.16	1.07	0.94
International Mail	0.94	1.01	1.05
Standard Mail (B)	0.97	0.99	0.95
Other	10.83	10.91	10.59
Total mail	197.94	190.89	183.44

is subdivided into four subcategories: regular, non-profit, enhanced carrier route (ECR), and nonprofit enhanced carrier route (non-ECR).

The volume of Standard Mail (A) grew 7.3 percent from 1997 to 1998, compared with a 7.8 percent increase from 1996 to 1997. This volume growth was more than twice our expectation of a 3.6 percent volume growth in 1998. Revenue grew 6.8 percent from 1997 to 1998, compared with the 5.8 percent increase from 1996 to 1997. The growth in Standard Mail (A) comes from both the ECR and non-ECR categories, with additional growth from non-ECR. Nonprofit ECR, on the other hand, consistently declined since 1995. Because Standard Mail (A) is particularly effective in reaching discrete target markets, advertisers and direct marketers are expanding their use of this class. Also, as we discuss above, we believe that many mailers have increased their use of Standard Mail (A) compared with First-Class Mail as a result of the 1996 classification reform. This change, which we expected, partially explains the strong growth in Standard Mail (A) from 1996 to 1997, and also from 1997 to 1998. We anticipate that volume growth in this category will remain in the 3 percent range.

Standard Mail (A) competes with a variety of advertising alternatives, including newspapers, television, radio, and telemarketing. We believe that advertising on the Internet poses a threat to the continued growth in the volume and revenues from Standard Mail (A).

As was the case with First-Class Mail, the per-piece cost of Standard Mail (A) actually declined from 1996 to 1997. Growth in costs on a unit basis is expected to remain moderate in 1998.

Priority Mail

Priority Mail, our most popular expedited delivery service, provides two- to three-day delivery of documents and parcels. We support Priority Mail with what we think has been an extremely effective advertising campaign that has positioned it as a

sensible alternative to high-priced, next-day products offered by a variety of companies. We think our advertising campaign is responsible for a portion of the growth in volume and revenue for this class of mail. With volume growth of 9.0 percent and revenue 7.6 percent over 1997, it is our fastest growing class of mail. However, we had anticipated a 10.0 percent volume growth in 1998. While this growth is lower than the 14.0 percent growth in volume and 16.1 percent growth in revenue for 1997, we think that part of that growth was due to the strike at United Parcel Service and that the growth in this class of mail will return to the 1995 to 1996 level of about 10 percent.

The unit costs of Priority Mail grew 4.1 percent from 1996 to 1997, slightly faster than the rate of inflation. Priority Mail operations have undergone substantial change in recent years with the expansion of dedicated seasonal air transportation and the implementation of the Priority Mail Processing Centers. Given these substantial changes, it is not possible to estimate the trend in Priority Mail unit cost for 1998. Nevertheless, management is committed to providing improved service for Priority Mail, including further implementation of delivery confirmation in 1999.

Standard Mail (B)

Standard Mail (B) is primarily parcels (Parcel Post) and Bound Printed Matter. In 1998, volume decreased 1.7 percent and revenue decreased 0.1 percent, which are substantially lower than the volume growth of 4.2 percent and revenue growth of 6.8 percent in 1997. In 1998, we expected a 5.5 percent volume growth in this category. However, our 1997 results were significantly affected by the strike at UPS. When we compare our 1998 results with 1996, we see that volume increased 2.4 percent, or roughly 1.2 percent per year, and revenue increased 6.7 percent, or roughly 3.3 percent per year. We expect volume in this class to continue to grow at approximately this same rate.

After a unit cost decline in 1996, Standard Mail (B) costs increased by 10.0 percent in 1997, which is partly reflective of extraordinary efforts to respond to mailer needs during the UPS strike. Industry adoption of drop-shipping increased in 1998, and this trend is expected to continue into 1999 with the implementation of new pricing incentives for entry of parcel post at Processing and Distribution Centers and Delivery Units.

Periodical Mail

Periodical Mail includes subscription magazines, newsletters, and newspapers. The delivery of this

mail is a central part of our public service charter, and it is an important class of mail both for the people who order and look forward to receiving these publications and for the publishers who use our services to deliver them. In 1998, volume decreased 0.9 percent and revenue grew 0.2 percent compared with 1997, which is substantially lower than the volume increase of 2.8 percent and revenue growth of 2.7 percent in 1997 compared with 1996. Historically, Periodicals volume has declined on a per capita basis as competition for the attention of the American public has intensified with the emergence of broadcast television, cable television, and most recently, the Internet as sources of news and information.

Although the unit cost of Periodicals mail was nearly unchanged in 1997, the Postal Service is responding to industry concerns over unit cost growth and complaints of poor service performance, particularly for small circulation periodicals. Improved flat sorting technology is expanding the availability of low-cost automated piece distribution to a wider variety of Periodicals. Additional technological advances will increase the speed and lower the cost of automated flats distribution operations. The National Periodicals Service Improvement Task Force is working on a variety of service solutions involving mail makeup changes, mail acceptance and information systems. Additionally, the Postal Service is developing training tailored to Periodicals mailers so they, too, can benefit from efficiencies resulting from the best mail preparation methodology.

International Mail

Rigorous competition and a weak international economy adversely affected international mail volumes in 1997. This trend continued during 1998. From 1997 to 1998, revenue declined 1.0 percent on a volume decline of 6.3 percent. The largest decline was in single piece mail—letters, cards, parcel post and others (technically LC, AO and CP). Three primary factors explain the decline: the adverse financial implications associated with the economic conditions in the Pacific Rim countries; the entrance of foreign postal administrations in the North American market; and the widespread use of the Internet. The Internet may explain a significant drop in mail to Canada. Overall, income was positive, exceeding 1997 by 5 percent. The increase in income was due primarily to lower expense levels. Two business products contributed to these results, Global Priority Mail (GPM) and International Priority Mail. Revenue increased 73 percent for GPM between 1997 and 1998.

**Global Priority Mail
reaches 33 countries
around the world.**



Expenses

Our discussion of Operating Expenses will focus on the two operating expense categories that make up almost 84 percent of our total expenses in 1998. These categories are Personnel Compensation and Benefits, and Transportation. Although not discussed here, interest on deferred retirement liabilities relates to the impact of changes to Personnel Benefits. The chart on page 43 presents the relative proportions of our major expense categories.

COMPENSATION AND BENEFITS

Personnel compensation and benefits grew \$1.8 billion or 4.0 percent over 1997 due to contractual wage increases, a 1 percent growth in workhours, and workers' compensation expense that was greater than last year. This compares with a growth of 2.7 percent in 1997 over 1996. In 1998, base salaries alone increased almost \$1 billion.

Most employees covered by our collective bargaining agreements in 1998 received a 1.2 percent general wage increase and semiannual cost of living adjustments (COLAs) of \$167 and \$208. In addition to receiving merit adjustments, lump-sum payments for individual performance, or both, most of our professional and management staff participated in the Postal Service's Economic Value Added (EVA) funded group incentive program.

An increased workload due to growth in mail volume, an expanding delivery network, and improvements in customer service along with contractual pay increases will drive compensation and benefits growth in 1999. Our current labor agreement with the National Rural Letter Carriers' Association will expire in November 1999. The terms

of this agreement include a \$400 lump sum payment in November 1998 and two COLAs in 1999.

Our contracts with the American Postal Workers Union and the National Postal Mail Handlers Union expired on November 20, 1998. However, we reached tentative agreements with both of these unions on December 2, 1998. The new agreements call for a 2 percent general pay increase plus two cost of living adjustments in 1999. These agreements must be ratified by each union's members. We have not yet concluded a new agreement with the National Association of Letter Carriers whose contract also expired in November 1998. Most of our nonbargaining employees will again participate in our merit pay and variable pay programs, which base compensation on individual and group corporate performance aligned with the *CustomerPerfect!* process.

RETIREMENT EXPENSES

We participate in a multi-employer retirement system. Essentially, our employees participate in one of the three retirement programs, under the auspices of the United States government's Office of Personnel Management (OPM), based on the starting date of their employment, as detailed in Note 6 of the Notes to Financial Statements.

Employees hired before January 1, 1984, are covered by the Civil Service Retirement System (CSRS). Approximately 38 percent of our employees are covered by CSRS. Employees with prior government experience hired between January 1, 1984, and January 1, 1987, are covered by the Dual CSRS/Social Security System. Approximately 2 percent of our employees participate in the "Dual" system. Employees hired on or after

"Many people don't realize what it takes to move the mail. Letter carriers, clerks, mail handlers, supervisors, drivers, and many others, work around the clock, 365 days a year, to ensure the safe delivery of the mail. It's an awesome task and a great responsibility which we carry out with great pride and dedication."

Clarence E. Lewis, Jr.
Chief Operating Officer and
Executive Vice President

MAIL PER CAPITA, REVENUE AND EXPENSE

(in units indicated)

	Years ended September 30,		
	1998	1997	1996
U.S. resident population July 1 estimate (in millions)	270.26	268.21	265.76
Percent change	0.8%	0.9%	0.9%
Pieces of mail per capita	732	712	690
Percent change	2.9%	3.1%	0.5%
Total operating revenue per capita	\$222.27	\$217.05	\$212.23
Percent change	2.4%	2.3%	2.9%
Total operating expense per piece of mail	\$0.2919	\$0.2875	\$0.2895
Percent change	1.6%	-0.7%	3.2%
Total operating revenue per piece of mail	\$0.3035	\$0.3050	\$0.3075
Percent change	-0.5%	-0.8%	2.4%
Net income per piece of mail	\$0.0028	\$0.0066	\$0.0085

January 1, 1984, with the exception of Dual employees and CSRS employees who have switched plans, are covered by the Federal Employees Retirement System (FERS). FERS employees are 60 percent of our total.

For the second consecutive year, the new layer arising from increases in basic pay for our CSRS employees was less than our annual payment to the OPM, resulting in a decrease to retirement liability. We attribute this trend, which we expect to continue, to both the declining number of employees covered by CSRS and to lower increases in basic pay.

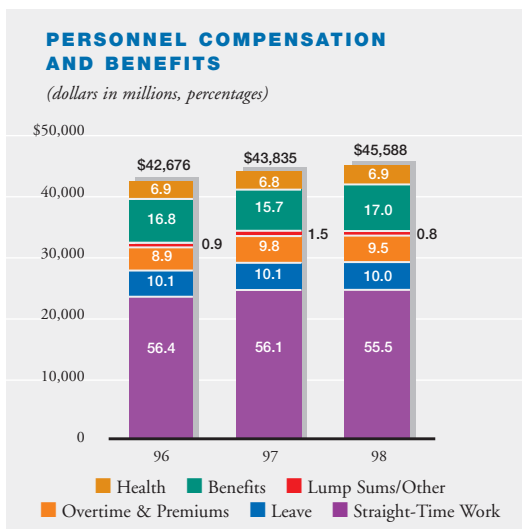
Because of low inflation, the layer arising from cost of living adjustments was less than in prior years. However, even with low inflation, we expect the new layers to be larger than our annual payments on the liability because our retiree/survivor population will increase, as will the proportion of their government service attributed to the Postal Service. Thus, we expect this liability to continue to grow over time.

In 1997, Congress approved a six month open season for workers covered by CSRS to switch to FERS. This open season ran from July 1998 to December 1998. While the final number of employees who chose to change systems was not determined at the time this report was prepared, preliminary figures showed only three-tenths of 1 percent of our employees had chosen to change to FERS. Based on this preliminary figure, we anticipate that less than 1 percent of our employees will make the change. The financial impact of this open season will be minimal.

The following table describes our retirement contributions as a percent of an employee's pay.

	FERS	CSRS
Basic Annuity	10.7%	7.0%
Social Security	6.2%	0.0%
Medicare	1.45%	1.45%
TSP	5.0%	0.0%

We have omitted CSRS deferred retirement expense from this table. Our year-end payment to OPM, including interest, was \$3.3 billion for our CSRS deferred retirement liability. We have no deferred retirement expense for FERS employees. This amount does not include \$347 million we paid for retroactive COLAs and health benefits. We discuss these contributions in more detail in Notes 4 and 6 of the Notes to Financial Statements.



While all employees may participate in the Thrift Savings Plan (TSP) as administered by the Federal Retirement Thrift Investment Board, the rules for participation are different for each group of employees. We do not match CSRS or Dual contributions to the TSP, and contributions are limited to 5 percent. However, we are required to make a contribution of 1 percent of basic pay to the TSP for FERS employees. In addition, we fully match employee contributions between 1 percent and 3 percent, and we match 50 percent of employee contributions between 3 and 5 percent.

We fully fund FERS, the Dual and CSRS systems according to OPM stipulations. But since the estimated long-term liability created by the increases to the basic pay for CSRS employees exceeds the legal funding requirements of the Postal Service, we record a deferred retirement liability on our books.

We are liable for the estimated increases in the deferred retirement liability of the CSRS Fund that are attributable to Postal Service employee/management agreements that increase employees' basic pay.

WORKERS' COMPENSATION

Under federal law, when postal employees are injured on the job, they are entitled to workers' compensation benefits. This means that we pay their lost wages and any medical bills related to their on-the-job injuries. Since we do not maintain workers' compensation insurance, we make such payments out of our own funds. Thus, our bottom line is affected every time an employee is injured and unable to return to work.

one
million
more

In 1998, we delivered mail to almost one million more addresses than in 1997.

In fact, accounting rules require that, if an employee is receiving workers' compensation, we must record a liability for the present value of all his or her expected future payments. Excluding claims relating to the operations of the old Post Office Department, the current average liability per employee claim for lost wages is about \$165,500 and the average liability per employee claim for medical bills is about \$9,400. In 1997, the average liabilities per claim were about \$165,000 for lost wages and \$8,100 for medical claims. At the end

198,000,000,000

We delivered 198 billion pieces of mail in 1998.

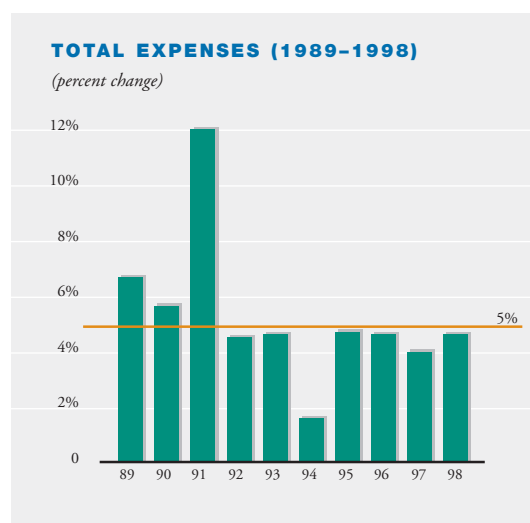
of 1998, we estimate our total liability for future workers' compensation costs at \$5,287 million. At the end of 1997, this liability was \$5,092 million. In 1998, we recorded \$760 million in workers' compensation expense compared with the \$206 million we recorded in 1997. We attribute the increase in expense, in large part, to increases in average cost per medical claim.

In the past, workers' compensation expenses tended to increase every year as more and more employees received payments for lost wages and medical treatment. Once injured employees were put "on the rolls," they tended to stay there. As recently as 1992, our annual workers' compensation costs exceeded \$1 billion. So we formed a task force to return to work all employees who are

able to return. The task force has worked hard to return employees to work and to terminate compensation for those employees who are able to work but who refuse valid job offers. This program continues, in expanded form, as the Return to Work Initiative. Our goal is to reduce the long-term periodic rolls by closer collaboration between postal medical and postal injury compensation personnel and to manage new injuries from the date of the injury or when we are notified. We have made other savings by auditing medical bills for duplicate payments and for inpatient over-billings when compared with state fee schedules. However, both the Return to Work Initiative and the auditing program will not affect our workers' compensation costs as much in the future as they have in the past. Many of the high-potential candidates for rehabilitation have already returned to work. Also, many of the large hospital bills have already been audited. Moreover, overall responsibility for this function rests with the Department of Labor, which is now in the process of seeking approval for implementation of a federal inpatient fee schedule similar to that used for Medicare. However, we will continue to audit medical bills for duplicate payments.

Our greatest opportunity for containing our workers' compensation expense is on "the front end" in the prevention of injuries. We have continued with an intensive study of how and where we work in order to identify anything that might contribute to the possibility of a worker being injured. Our back-to-basics program called Second-to-None establishes a formal methodology to track progress in creating a safer working environment. In addition, an important objective of our capital investment program is to add equipment that will reduce the number of on-the-job injuries. Consequently, in 1998 we saw the second consecutive decrease in the number of injuries we reported to the Department of Labor.

We believe that the emphasis on early and proactive case management is critical when an injury occurs. In this regard, we are refocusing our efforts on early claims management. In prior years, we hired additional employees to research claims for workers' compensation, increased the funding for fraud investigations, added 25 postal inspectors for fraud investigations and implemented the Nurse Coordination Program (NCP). Next



Expense growth has been held to under 5 percent for seven straight years.

ANALYSIS OF EXPENSES

(in percent)

	1998	1997	1996
Personnel compensation	58.28%	59.47%	59.24%
Personnel benefits	18.27	17.35	18.39
Transportation	7.06	7.05	6.80
Supplies and services	5.15	3.91	4.10
Interest on deferred retirement	2.68	2.80	2.64
Depreciation and write-offs	2.71	2.99	2.45
Other	1.69	1.72	2.14
Rent and communications	1.64	1.52	1.47
Vehicle/building maintenance	1.00	0.96	0.92
Utilities	0.73	0.77	0.75
Advertising	0.51	0.47	0.43
Interest	0.28	0.54	0.67
POD workers' compensation costs	-	0.45	-
Total	100.00%	100.00%	100.00%

year, we will be expanding this program to an additional 30 sites. This pilot program uses early nurse intervention to assist in the return of claimants to productive work. We believe that this program will succeed in reducing compensation claims costs in the long run, despite the anticipated short-term increases in medical costs.

We remain serious about managing our current claims and preventing new claims. In 1999, we will make additional funding available to our field offices for local cost control efforts. We also remain serious about eliminating fraudulent claims. We are so serious, in fact, that we now offer a reward of \$10,000 to anyone who gives us any information that leads to the arrest and conviction of any current or former employee, or medical service provider, who has defrauded the workers' compensation program. Anyone with any such information can make a confidential call to the Office of the Inspector General at 1-800-654-8896.

Under the Postal Reorganization Act of 1971, the U.S. government remained responsible for the payment of all workers' compensation claims for workers who were injured while working for the old Post Office Department. Under this Act, the newly created Postal Service would be responsible only for its own workers' compensation claims. However, in the Balanced Budget Act of 1997

Congress transferred the old Post Office workers' compensation costs to the Postal Service. We estimate the present value of these claims to be \$231 million and have recorded this year's expense of \$8 million.

TRANSPORTATION

Our transportation expenses grew because of an increase in our mail volume and our concentrated efforts to improve two- to three-day First-Class service. Our transportation expenses increased \$181 million or 4.5 percent, compared with 1997. This compares with an increase of \$290 million or 7.8 percent from 1996 to 1997.

The increase between 1997 and 1998 is due in large part to the increase in volume of mail handled. In 1998, we handled almost 198 billion pieces of mail, and in 1997 the number was almost 191 billion.

That is an increase of over 7 billion pieces or 3.7 percent.

Another reason for the increase is our new emphasis on improving our two- to three-day service levels.

Improvement required us to increase the use of highway mail transportation systems in order to meet our scheduled delivery times. We have also shifted more mail to our highway hub system since for trips of less than 600 miles it is more efficient to use surface transportation. As long as we continue to improve our level of service and expand these systems, we expect our transportation costs to continue to grow.

Notably, our transportation costs did not increase this year at the same level as experienced between 1996 and 1997. This was primarily due to changing fuel prices. While fuel prices increased 7.6 percent between 1996 and 1997, they decreased 12.3 percent between 1997 and 1998. This decrease partially offset increases to our transportation costs due to efforts to improve service. Our transportation costs are also dependent upon our contract rates with major airlines and others who provide us mail transportation services, as these companies can pass along to us the increase in their labor and other costs.

293,000
letter
carriers
41.5 tons
of mail
each

Each of our 293,000 letter carriers delivered an average of 41.5 tons of mail in 1998. That's equivalent to carrying ten average-sized male elephants.

Other Issues

In this section we discuss the other issues that we think may affect us. We discuss the Breast Cancer Research semipostal stamp, recent legislative activity, productivity, recent postal legislation, recent classification reforms, environmental issues, *CustomerPerfect!*, our efforts to have our computers ready for the year 2000, and the effects of inflation.

Of course, we can't be sure that our views on the following issues are accurate, but the discussion represents our best judgment of what we think is relevant to our present and future operations. Actual results may well be different from our best estimates.

BREAST CANCER RESEARCH SEMIPOSTAL STAMP

On July 29, 1998, the Postal Service issued its Breast Cancer Research semipostal stamp. This is the first U.S. stamp whose net proceeds above the cost of postage are designated for research organizations. The Governors' established price of the stamp is 40 cents and is valid for postage up to the 32-cent First-Class letter rate. Seventy percent of the net proceeds above the cost of postage are assigned to the National Institutes of Health and 30 percent to the Medical Research Program of the Department of Defense. As of September 30, the stamp has produced revenues of almost \$12 million, with almost \$2.4 million in donations.



"This deadly disease, which claims a woman's life every 12 minutes, has touched the lives of so many American families.... This historic stamp will be invaluable in our efforts to increase research funding and save lives."

Hillary Rodham Clinton
First Lady

RECENT LEGISLATIVE ACTIVITY

In 1998, Congress passed legislation that applied private sector provisions of the Occupational Safety and Health Act (OSHA) to the United States Postal Service. Prior to the passage of the bill, the Postal Service followed OSHA guidelines applicable to other federal sector agencies.

Last year, the postal community had the opportunity to respond to provisions and revisions of postal reform legislation introduced by Congressman John McHugh, Chairman of the House Subcommittee on the Postal Service. Consideration of Chairman McHugh's bill will resume upon reintroduction in the 106th Congress.

PRODUCTIVITY

We use several measures to track productivity. One of these is the Total Factor Productivity (TFP) measurement system. This system measures the changes between outputs and the resources used to produce the outputs and provides a means to measure productivity over time. A comparable measure of productivity in the private sector is Multifactor Productivity (MFP) for nonfarm business, which is reported by the Bureau of Labor Statistics. TFP is best used to analyze long-term trends and is not effective as a short-term measure or snapshot in time.

Our goal, as outlined in our Five-Year Strategic Plan, is to improve our TFP over time at a rate that at least equals or exceeds any improvement in the private sector MFP. Postal Service Total Factor Productivity since 1990 has increased at an average annual rate of 2.3 percent, which compares with the 2.6 percent gain reported for MFP. The gap between these two numbers illustrates the danger of using a statistic without reviewing the trend behind it. Last year we were ahead of the private sector, but because we increased our capital investments and converted many transitional employees to career status we have a temporary fluctuation in our TFP. This fluctuation is a lag between the capital investments we have made to improve productivity and the savings we have yet to realize from these investments. TFP is best used to analyze long-term trends and is not effective as a short-term measure or snapshot in time.

We balance our objective to improve our productivity with our objective to improve customer service. Because our TFP does not include a measure of service quality, our TFP may decline in the short term because some of our investments improve service but do not improve productivity.

CLASSIFICATION AND RATE CHANGES

In 1998, the Governors approved a new rate structure that increases rates an average of 2.9 percent, the smallest rate increase in our history. The new rate structure also provides increased economic incentives for our customers to prepare their mail in ways that reduce our costs and help hold down rate increases. However, the Board voted to delay implementing the new rates until January 10, 1999. The new rates include a one-cent increase for First-Class letters as requested by the Postal Service. The rates for other classes of mail will also increase modestly: 5.6 percent for Priority Mail, 8.1 percent for Express Mail, 4.6 percent for Regular Rate Periodicals, 6.8 percent for Nonprofit Periodicals, 3.5 percent for commercial Standard (A), 8.7 percent for nonprofit Standard (A), 12.4 percent for Parcel Post, and 11 percent for special services. In addition, we can now offer new worksharing rate categories for Parcel Post and delivery confirmation for Priority and Standard (B) mailers. Also, we will now be able to offer our Parcel Post customers the same discounts we presently offer our Periodical and Standard (A) customers for barcoding, presorting, and drop-shipping their mail. And we will be able to offer the parcel shipping public delivery confirmation, signature service, and bulk insurance.

Generally, the new rate structure provides more opportunities for our customers to reduce their mailing costs, while it allows us the opportunity to offer our customers new services. We can now offer our Periodical customers a new presort discount, and our Standard (A) customers can reduce their costs by using more barcoding. In addition, the rates for bound printed matter have been revamped to better reward those customers who transport their mail closer to the point of delivery.

In June, the Board of Governors approved a filing with the Rate Commission to test market the experimental versions of Mailing Online service. Mailing Online allows customers to send electronic documents and mailing lists to the Postal Service via the Internet. The system then transmits the documents to private printers who produce automation-compatible mail pieces for entry at designated Postal Service facilities. The market test, which will be conducted in the Northeastern United States, will test customer acceptance, while allowing us to gain experience in providing the service at multiple locations on a national level. Hearings on our request were held in August 1998, and we hope to have a

Recommended Decision in time for a national introduction of the service in 1999.

The Commission also issued its Recommended Decision on Provisional Packaging Service affirming the legal basis for the Postal Service's introduction of the service. This new service will offer customers the convenience of having their parcels packaged and mailed at one location. However, in addition to recommending fees higher than those proposed by the Postal Service, the Commission imposed a requirement that the Postal Service indemnify all articles sent via Pack and Send against damage. Because of these recommendations, we will study this proposal further before deciding whether we implement this service.

ENVIRONMENTAL MATTERS

Because we want a safe and healthy environment for our employees and customers, we have set high goals for our environmental policy, and we are meeting them. In 1993, we developed our Environmental Strategic Plan, which focuses on leadership and compliance. Since 1995, we have received 24 White House "Closing the Circle Awards" for our pollution prevention and recycling accomplishments. During 1998, we recycled about 1 million tons of waste paper, cardboard, plastics, cans and other material. These recycling activities generated about \$4 million in revenue.

We promote pollution prevention, we do all that we can to reduce waste, and we recycle and reuse materials wherever possible. In 1998 we expanded our use of linerless labels. We expect to save \$40 million from using these labels, as well as avoiding the generation of 678 tons of scrap paper waste. We use recycled materials for our products. We use "green products" to maintain our equipment, and we are a national leader in the use of re-refined oil and retreaded tires. We buy over 100,000 retreaded tires each year for our vehicles, and we use re-refined oil in over 100,000 vehicles.

We are an industry leader in using environmentally friendly packaging materials for our Priority Mail service. We use a paperboard envelope that is 100 percent recycled with a minimum of 80 percent postconsumer fiber. Our envelopes also have no impediments to recycling such as a plastic document window. A report by The Alliance for Environmental Innovation and a letter from the Federal Environmental Executive to the General Services Administration (GSA) have both suggested expanding use of Express Mail based on our environmental record.



"We continued to move forward this year on the people side of the business. Now more than ever employees and management are working together to try new approaches. For example, a new system of dispute resolution, bringing in a neutral third party to help resolve EEO issues, has had very positive results."

Mary S. Elcano
Senior Vice President and
General Counsel

seven
million

Every business day
7 million customers
visit our post offices.

A recent study found that the use of Standard Mail (A) has very positive environmental benefits. Standard Mail (A) consists of advertisements from mail order companies, publishers, department stores, and financial institutions. This mail produces an estimated net economic benefit of \$275 million per year in environmental impact. The study found that because consumers used Standard Mail (A) to shop from home, they made fewer automobile trips to stores, thus reducing pollution, the amount of gasoline consumed, and other environmental benefits.

In Ft. Worth, Texas, we are building an experimental retail and delivery station with recycled materials, drought-resistant native landscaping, high-efficiency heating and cooling systems, anti-glare full-spectrum lighting, skylights for natural lighting and trellises for shading. The interior wall panels are made of recycled wood glued together and filled with straw insulation, while recycled materials taken from old highways are used in the concrete. Structural beams are made of recycled steel, and a roof-mounted water collection system will provide rainwater for the landscaping. The exterior paint and the roof are designed to reflect light and reduce heat. This building will provide us with a test site where we can compare cost, performance, maintenance and aesthetics to standard construction. What works can then be incorporated into other buildings.

We are involved in various litigation and have unresolved claims pending related to environmental matters. We believe that we have made adequate provision in our accounts for the amounts which may become due under these claims. We are of the opinion that such liability is not likely to be of significant importance in relation to our accounts.

CUSTOMERPERFECT!

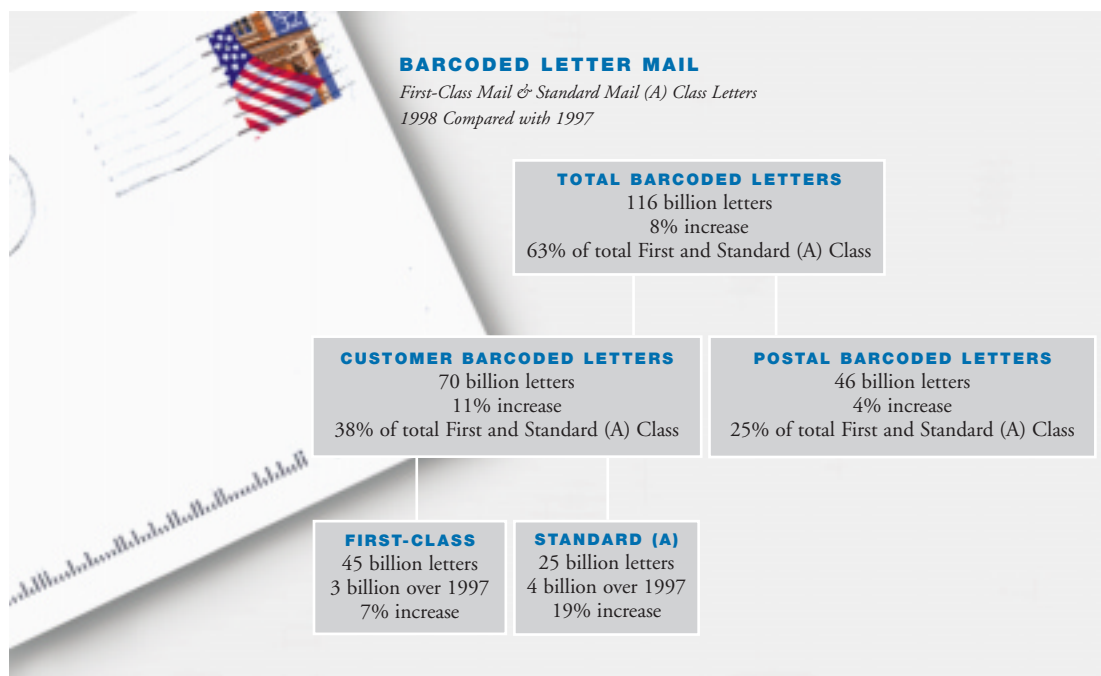
Three years ago, we conducted our first assessment based on the Malcolm Baldrige Award criteria. As a result of that assessment, we created the management system we call *CustomerPerfect!*, which focuses on our customers' needs and how we can better meet those needs. The approaches being taken through *CustomerPerfect!* are weaving their way through the fabric of the Postal Service and the way we do business. Our customer focus is becoming real through an understanding of our processes and how these work together to provide our services and products.

This year, we reviewed and renewed our commitment to *CustomerPerfect!* by conducting another assessment based on Baldrige criteria. This assessment documented our progress since the last assessment and identified five key areas on which we will focus. Based on this new assessment, we will work to:

- improve communication and relationships with employees and the bargaining units that represent them;

In Ft. Worth, Texas, our experimental "green" building shows our commitment to cooperating with the environment.





Customers continued to barcode larger amounts of their mail, helping us to reduce costs, increase efficiency, and serve our customers better.

- define the human resource implications of our strategic business objectives and develop human resource plans accordingly;
- standardize our core processes across all operations, making sure to leverage those approaches that are most effective in helping us to meet our performance objectives;
- develop a strategy for identifying, collecting, and using comparative data with which to evaluate our performance; and
- affirm the identity of the Postal Service to ensure that there is no ambiguity of purpose or direction.

For each of these areas, we have assigned an officer of the Postal Service the responsibility for planning and implementing appropriate action. We expect to see further improvements in our performance in the coming years.

YEAR 2000 PREPARATIONS

The Year 2000 problem stems from the nearly universal computer programming practice since the advent of the computers of using two rather than four digits to designate the calendar year. As a result of this and related practices, dates in 1999 and beyond can lead to problems in computer operations date translations, which in turn can lead to errors in data, incorrect conclusions based on erroneous data, and possibly interruptions in automated services. Since we are so highly automated

and dependent on computers in both mail processing and administrative systems, the Postal Service has assigned the highest priority to activities that address the Year 2000 problem. Though technical in origin, this is a business problem that touches on all aspects of not just internal operations but those of our key vendors and service providers as well. Commitment to the success of the Year 2000 remediation efforts begins with the Postmaster General and extends, through the senior officers, to those assigned to take action.

Corrective actions on hardware and software computer components generally involve four phases: assessment, remediation, testing, and implementation. To date, we have completed our assessments of major corporate systems applications, computing and mail processing equipment, and other computer-based components. Focusing first on those components which support the most critical business operations, we have determined which hardware and software components have known or potential Year 2000-related problems. Once the responsible business manager has certified the mission critical applications as ready for Year 2000, we require that an independent verification be conducted. As of September 15, 1998, we had completed the remediation phase of 106 of 153 mission critical systems. We expect to complete remediation and verification activities on mission critical applications by the end of June 1999.

Small Parcel and Bundle Sorters reduce repetitive lifting, lowering our employees' risk for injury.



We plan to conduct readiness testing across several critical business processes and their interfaces in 1999. Because failures may occur in spite of our best efforts, we are also developing contingency plans to ensure business continuity.

We are also actively assessing the Year 2000 readiness of our suppliers and the business partners who exchange information with us. In today's business environment, we deal successfully with isolated failures of suppliers and information exchange partners. However, the Year 2000 problem poses the threat of a simultaneous failure of a number of suppliers or partners that could negatively impact our operations. Beginning with suppliers and partners identified as critical to our operations, we will continue to perform assessments, evaluate our alternatives, and where indicated, develop contingency plans for business continuity.

To evaluate the readiness of the mail processing systems, we tested the automated mail processing equipment at a major mail processing plant in Tampa and a bulk mail center in Atlanta. Both tests verified that our equipment will process letters, flats and parcels correctly to and through the Year 2000. Our ability to deliver mail could be disrupted by the failure of our transportation partners. For example, airlines route planes using computers, and we rely on their systems for almost 15,000 flights daily. Should the airlines fail, we could move the mail using alternative means of transportation, but it would take additional time. Finally, our ability to deliver mail could be partially

affected by problems in ancillary services like stamp sales, postal meter operations, or in our ability to conduct automated financial transactions. We have undertaken or are engaged in a broad range of activities to mitigate any impact in these areas. Considering all possible internal and external events that could occur, it is possible that sometime during the Year 2000 we could experience delays for some types of mail. We believe such events would be restricted to relatively small geographic areas and will be effectively dealt with utilizing the contingency plans we are developing.

We are complementing our experienced internal resources with dedicated support from leading Year 2000 service providers. The total cost of Year 2000 activities is being funded through operating cash flows and is expected to approach \$500-600 million through September 2000. So far, we have spent approximately \$94 million remediating systems for Year 2000 readiness and managing our overall Year 2000 efforts.

INFLATION

We are a labor intensive business with approximately 77 percent of our costs attributable to personnel compensation and benefits. Therefore, inflation, as reflected in rising labor wage rates, significantly affects our financial condition. We reached tentative agreements with two of the three unions whose contracts expired in November 1998 and are negotiating with the third union. We expect that the increased labor costs resulting from these contracts will be in line with the expected rate of inflation.

Analysis of Liquidity

Liquidity is the cash we have in the bank (the Postal Service Fund) and the amount of money we can borrow immediately if needed. By law, we can borrow money only after notifying and offering the debt to the Secretary of the Treasury. Because Treasury has exercised its right of first refusal in recent years, an important part of our liquidity management program is negotiating solutions to our financing needs with the Department of Treasury and its Federal Financing Bank, which has been our lender. We manage our cash so that we meet our obligations and use any excess to reduce our debt or earn interest to get the most from our money.

During 1998, cash receipts totaled approximately \$60 billion, not including financing and the face value of money orders. Once again, we set a record for the amount we received in one day. On January 21, 1998, we took in over \$543 million, and we collected over \$500 million on seven other occasions. That's a lot of money to manage effectively, but managing it well can produce significant benefits for us and ultimately our customers. During the last six years we have conducted a very aggressive liquidity management program. We designed this program to ensure we have enough cash and borrowing ability to meet our daily needs and invest in capital improvements, while we minimize our cash on hand and our debt. Our capital investments are designed to increase our productivity and efficiency so we can lower our costs while providing better service.

MINIMIZING CASH AND REDUCING DEBT

Minimizing cash and debt to control interest expense and risk has been a challenge. In 1992, the Postal Service had \$9.9 billion in debt outstanding, paid \$765 million in interest expense on our debt, while cash and securities in the Postal Service Fund averaged \$6 billion. By 1997, we reduced the debt outstanding to \$5.9 billion and the average cash balance to \$1.8 billion. We have used our liquidity management program to further reduce our cash on hand to an average of \$287 million during 1998. On September 30, 1998, we had approximately \$395 million cash and cash equivalents on hand. That is not a lot of cash considering that our payroll every two weeks is typically over \$1.6 billion.

Over the past few years we have worked closely with our lender to put in place the tools we need to manage our cash more effectively. Successful debt management should be viewed as

an ongoing multiyear journey rather than a final destination. Major milestones in this journey have included obtaining call options (1992), making decisions to minimize cash and debt (1993), negotiating floating rate debt that can be repaid quarterly without penalty (1994), obtaining revolving credit lines of \$1 billion (1996), tripling our credit line facilities to \$3 billion (1997), and obtaining notes that we can borrow against with short notice (1998). These new financing tools give us unprecedented flexibility in addition to reducing the time it takes to borrow to only two days. In the past, it often took more than a month to complete the same financing. With these tools finally in place last year, we were able to use them to manage our liquidity to achieve the best results.

Entering the fiscal year, we had restructured our debt portfolio so that \$5.1 billion of our \$5.9 billion in outstanding debt could be repaid without penalty in 1998. This restructuring allowed us to manage our daily liquidity aggressively, resulting in a near zero ending cash balance on 117 business days and an average of \$287 million for the year compared with four days in 1997 and an average of \$1.8 billion.

Over the years, we reduced cash and debt by focusing on cash flow forecasting and by increasing our ability to adjust debt. In late 1992, all of our \$9.9 billion debt was fixed-rate and non-callable. On September 30, 1998, only 45 percent of our \$6.4 billion debt was fixed-rate and non-callable, 9 percent was floating rate, and the remaining debt was against short-term credit lines. An important part of our liquidity management program is the short-term credit lines we negotiated in 1996. With these lines of credit we can reduce the cash we keep on hand to meet our liquidity needs. The Overnight Revolving Credit Facility allows us to borrow up to \$300 million on the same day we request it. The Short-Term Revolving Credit Facility allows us to borrow up to \$2.7 billion with two days' notification.

Using these lines of credit, we saved paying substantial interest on two long-term notes. The first note for \$1.5 billion carried an interest rate of 7.367 percent, and the second note for \$1.0 billion carried an interest rate of 7.615 percent. These notes were the last remaining from the November 1992 debt restructuring. On December 1, 1997, we refinanced both notes at the first opportunity to call them using a combination of our overnight revolving credit facility, which had an interest rate of 5.52 percent, and our short-term revolving credit facility and new floating rate note, each of which had a 5.34 percent interest rate.



"We are at a critical crossroads in the history of the U.S. Postal Service. Over the past two years, Congress has taken major steps toward attempting to define our role as it relates to the interests of the public and private sectors. We are playing a leadership role in the process to create effective, productive reform."

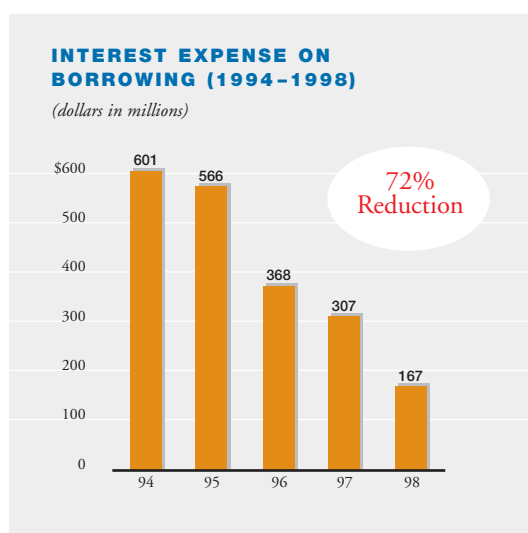
Deborah K. Willhite
Senior Vice President,
Government Relations

Our strategy is
to minimize
our debt . . .



Successful debt management should include a strategic balance of both long- and short-term considerations. In 1998 we took advantage of declining long-term interest rates to lock in some very attractive financing that will serve to hold down interest expense in future years. In January 1998, we issued \$1 billion of long-term debt at an average interest rate of 5.77 percent, our first long-term borrowing in over two years. In July, we issued \$250 million more of long-term debt at an average of 5.62 percent, and in August we added an additional \$500 million at 5.53 percent. Finally, in September we added \$400 million at an average rate of 4.95 percent—the lowest long-term borrowing rate in Postal Service history and our first borrowing of any kind below 5 percent.

. . . and reduce our
interest expense.



For 1998, our interest expense on borrowings was \$167 million, which is a decrease of \$140 million or 46 percent from 1997, and a \$434 million decrease from our 1994 financing expense of \$601 million. That is a 72 percent decrease in financing expenses in just four years. Since 1994, we have reduced debt 29 percent, from \$9 billion to \$6.4 billion on September 30, 1998. The weighted average rate of interest on long-term debt decreased from 7.35 percent in 1997 to 5.89 percent in 1998. Meanwhile, the average years to maturity for the debt expanded to 13.45 years from 6.76 years at the end of 1997. However, as we cautioned last year, our cash flow from operating activities declined during 1998 while our capital cash outlays remained in excess of \$3 billion, resulting in an increase in our outstanding debt at the end of 1998 of \$549 million. Yet while our outstanding debt increased, our interest expenses decreased due to a combination of reducing the interest rate on our debt and managing our debt to lower levels throughout the year.

While we anticipate that our operating activities in 1999 will continue to provide us with sufficient cash flow to cover expected obligations, they should also result in an increase in our debt outstanding similar to the increase in 1998.

AWARD WINNING CASH MANAGEMENT

Our liquidity management program has been very successful and has earned national recognition. In fact, *Treasury & Risk Management* magazine awarded us their 1998 Gold Alexander Hamilton Award for Cash Management and the Bronze Award for Excellence in Corporate Finance.

The Postal Service received the award in Corporate Finance for our liquidity management program of improving the balance sheet and income statement by reducing cash, debt, interest expense and risk. We were able to change the environment in which we operated in order to achieve the flexibility needed to manage our balance sheet. We were able to make changes both internally through increased awareness of debt management and emphasis of strong financial performance and externally through negotiated solutions to our business needs. The successful results of our program were discussed in the preceding section.

We received the Gold Alexander Hamilton Award for Cash Management for implementing innovative solutions to managing electronic



Treasury & Risk Management magazine awarded us their 1998 Gold Alexander Hamilton Award for Cash Management and the Bronze Award for Excellence in Corporate Finance.

payments from customers. To meet customer demand for more convenient payment options, we completed one of the largest roll-outs of debit/credit cards acceptance in history involving four major credit cards and all on-line debit card networks. This program included training 100,000 personnel and installing over 60,000 terminals at 33,000 locations. The Postal Service is also promoting the use of electronic payments from our business customers through the use of Automated Clearing House transfers and Fed Wire payments. Designing, implementing, and managing such large and complex electronic payment systems was a daunting challenge. To manage this task, we created a new group within Corporate Treasury in 1997.

We also created a cross-functional team that first pulled together the diverse postal management units involved in the project and then worked to develop a set of common cohesive management strategies and policies for electronic payment technologies that made the system run smoothly.

In addition to meeting our customers' needs with an award winning system, electronic payments save us money. Our studies show that processing electronic payments is much less expensive than handling cash or checks. We expanded the dollar amount of the payments we receive electronically from 11 percent of total cash receipts in 1997 to 15 percent during 1998. And we continue to pursue new payment options for all customers.

RELATIONSHIP BANKING

During the past year we continued our program to streamline and strengthen our bank relationships.

By consolidating and competitively bidding our accounts we not only obtain better service and rates from banks, but we also improve financial controls, minimize our costs, and leverage our position as a major corporate customer.

Through September 1998 we signed 29 contracts providing banking services for post offices in 42 states with an estimated two-year savings of \$20 to \$25 million. In October 1998 we signed contracts covering an additional three states and plan to complete the process. Since we began our relationship banking program, we have reduced the number of banks with which we do business from over 5,000 to fewer than 100, of which 27 are major relationship banks which handle most of our business. We select banks that offer experience, innovation and superior technology and deal with us as they do with their other large business customers.

We have also continued our Minority Bank Certificate of Deposit Program with 69 participants.

We began this program in 1996 to demonstrate our support for both the U.S. Treasury's Minority Bank Deposit Program and the minority bank community. Minority banks must meet select qualification criteria to participate in our program, which allows us to place \$100,000 certificates of deposit in qualified institutions. We will continue to monitor eligibility standards for financial control purposes and to increase enrollment in the program.

During the year we engineered a seamless shift of our payroll disbursement account from the U.S. Treasury to four commercial banks. This major undertaking involved extensive coordination with many internal functional areas as well as external coordination with our relationship banks. The change has given us better financial controls, improved cash management and cost savings. Our employees also benefit from reduced inquiry time and faster processing of lost checks. Approximately 375,000 postal employee paychecks are drawn on these banks. This change did not affect the remaining 400,000 postal employees who have direct deposit of their paychecks.

**\$200 million
every
business
day**

During 1998 we took in more than \$200 million every business day, and on eight of those days, we took in more than \$500 million, with a record \$554 million in one day.

Analysis of Capital

The Capital Budget has seen dramatic changes during the last decade. During the early seventies our capital plans did not exceed \$1 billion. However, during the eighties and nineties our capital budget plans have increased significantly as we have aggressively pursued innovative and prudent investments. Our capital plans are designed to give us the tools we need to meet the challenges of improving mail service, maintaining a positive net income, ensuring good working conditions for our employees, providing positive customer relations, increasing management effectiveness, and reducing our operating costs by using the latest technology.

43
million

Every year we
process 43 million
address changes.

Our present five-year Capital Investment Plan is the result of thorough planning at all management levels. The individual projects in the plan are intended to support one or more of our *CustomerPerfect!* goals or strategic objectives. Although the Capital Investment Plan supports our basic mission of providing universal mail service to all of our customers, each project within the plan is subjected to a rigorous review, validation, and approval process designed to ensure the project is justified.

The timing of the relationship between the Capital Investment Plan, the financing plan, and balance sheet recognition is important. The commitments we identify in the Capital Investment Plan represent expected contract awards or options. We do not generally pay until the goods are delivered or a contractor meets its progress schedule. It is important to note that this entire process—from project approval, contract award, cash payments, capitalization, to any expected return on investment—can take a long time.

REVIEW OF CAPITAL INVESTMENTS

We subject all projects in the approved Plan to an intense review and approval process that ensures they are fiscally sound or service oriented. We establish accountability for the results we expect the project to produce. During the implementation of the project, we measure the project's operating and financial goals. Finally, when the project is completed, we may conduct an after-cost study and Inspection Service audit. All projects within the purview of the Capital Investment Committee follow this four step process.

1998 CAPITAL INVESTMENT PLAN

This is the third consecutive year that we have had record level capital commitments of over \$3 billion. During 1998, the Board approved a total of \$2.3 billion for 27 major capital investment projects, consisting of 11 facility projects, 14 equipment projects and 2 vehicle projects. We made commitments for the majority of these projects. And we expect to continue this high level of planned commitments for the next several years.

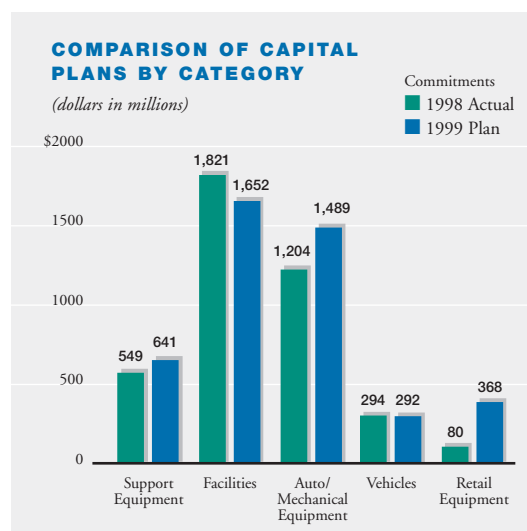
Almost 50 percent of our 1998 commitments, \$1.8 billion, was attributable to building or improving facilities. The facility investments mainly satisfy capacity requirements because of the growth in population, mail volume, and delivery points. There is also an inventory of aging facilities that require repair or replacement. Properly maintaining our existing assets extends their useful lives, provides a business-friendly environment for our customers, and enhances working conditions for our employees.

We committed \$1.2 billion for such labor-saving mail processing equipment as Advanced Facer Cancellor Systems and Flat Sorting Machines 1000 Bar Code Readers.

Vehicle commitments of \$294 million continued to sustain our five-year vehicle strategic plan to deploy trailers and delivery and collection vehicles. Retail commitments consisted mostly of service-related equipment to support our retail infrastructure.

1999 CAPITAL INVESTMENT PLAN

Postal Service bylaws require that the Board of Governors approve the capital budget each year.

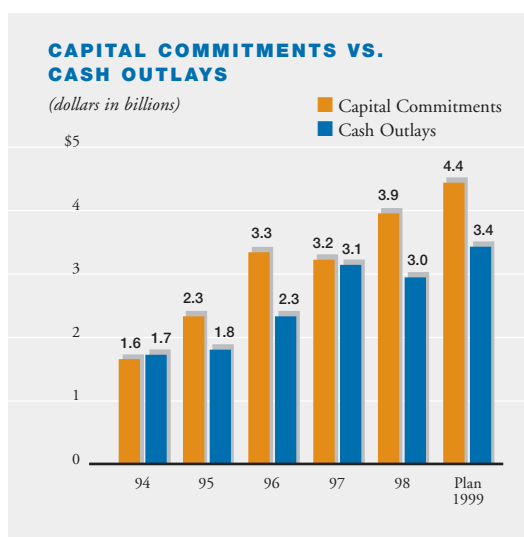


This process usually occurs between August and October. At its September 1998 meeting, the Board of Governors approved a 1999 Capital Investment Plan of \$4.4 billion for 1999 and confirmed our \$17 billion plan through 2002. The Capital Investment Plan is a five-year investment cycle for 1998–2002. The first year represents the budget year while the remaining four years represent a plan that will be reviewed by senior executives and the Capital Strategic Planning Committee. Normally, the Board of Governors would approve a five-year plan, but this year we recommended keeping the current \$17 billion plan for five years and adjusting our year allocations. Only the Capital Investment Plan for 1999 was approved by the Board of Governors. To reduce borrowing, we will use internally generated funds as much as possible.

Projects for 1999 include such carryover projects from 1998 as Delivery Confirmation, asbestos removal, and projects with special funding. These projects are designed to meet the demands of the growth in our workload, repairing and replacing our aging infrastructure, and making use of the latest technology.

The facility component is the single largest component at \$1.7 billion. For field projects of less than \$5 million each, we have planned a total of \$1 billion. This includes funding for over 300 projects for expansion and new construction of small facilities and funding for over 1,600 repair and alteration projects. There is \$417 million projected for commitments for 25 major processing facilities. Funds have been included to modernize the 25-year-old facility housing Headquarters. Major systems are in need of upgrading or replacement such as lighting, air handling, electrical and communications. We will continue our Bulk Mail Center (BMC) Expansion program that allows the BMC network to handle in an efficient and more timely manner future growth in the volume of pallets and large parcels.

At \$1.5 billion the equipment budget is the second largest portion of planned capital spending. This budget includes \$899 million for material handling projects that will automate the transportation and preparation of mail trays, \$307 million to upgrade currently installed Delivery Bar Code Sorters and \$221 million to improve the Small Parcel Bundle Sorter Feed System, install the new Smart Delivery Unit and upgrade the existing



Flat Sorting Machines 1000 series with the Flat Sorting Machine 1000 Optical Character Reader.

We also plan to invest \$518 million in such infrastructure projects as centralized telecommunications, automatic data processing and support for new computer applications.

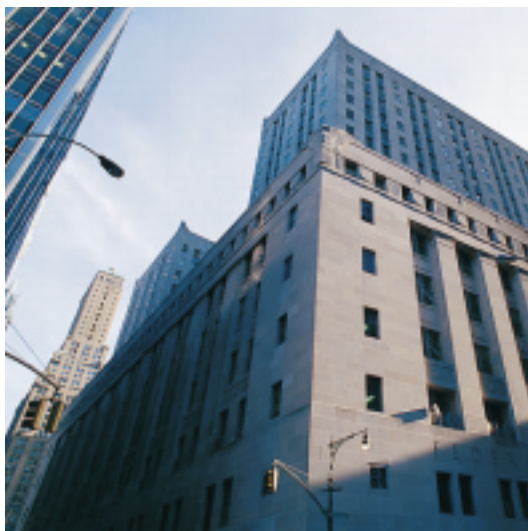
We will commit \$509 million to such Special Projects as Stage 2 of the deployment of our point of service or POS ONE System, construction of our International Service Centers to improve service for international and military mail, expanding our delivery confirmation capabilities and expanding our Corporate Call Management system.

Finally, we will spend \$292 million to replace and upgrade our vehicle fleet, as well as \$70 million to improve our retail services with new vending machines and customer support services.

All of the projects in our 1999 Capital Investment Plan are designed to promote one or more of our three basic goals: improve service to our customers, produce an economic return through cost savings, and improve working conditions and infrastructure.

While making capital investments to achieve these goals is important, we realize also that we are a part of the communities in which we work and which we serve. When we build a new building or rehabilitate an older one, we can affect the life of the community where we make that investment. So we try whenever possible to work with the local community so that we can help each other. The following projects are examples of our efforts to work with local communities even as we work to build a better Postal Service.

In cooperation with local government, we are renovating the historic Church Street Station in New York City.



Space in New York City is scarce and expensive, so when we decided to renovate the Church Street Station in lower Manhattan, we looked for ways to use the building that were economically sound yet still served the community. Located adjacent to the Civic Center and World Trade districts, Church Street Station is a 1 million square foot post office and former federal office building listed on the National Register of Historic Places. Built in 1938, this limestone art deco building housed a post office and federal office tenants for 60 years. With the construction of a

new federal building, we had the opportunity to renovate the building into a state-of-the-art office building and postal facility. The building offers the quality of space and layout normally found only in modern buildings but which most of the older

buildings in this area lack. Two public service agencies have taken long-term leases on all vacant space in the building. The Legal Aid Society of New York, the public defender for the City of New York, moved into 150,000 square feet of renovated space in July 1997, while the New York City Housing Authority has signed a lease for 450,000 square feet and will move in during late 1999. The renovation of the building includes improved public access and restoration of significant historic building elements such as the public lobby fronting on Church Street. In addition, by 2002 we will completely renovate and upgrade the rest of the building to improve working conditions for our employees.

The Brooklyn General Post Office is a historic Romanesque structure constructed in 1885

and expanded in 1933. Originally built as a post office and federal courthouse, the courts and most of the postal operations moved to other locations over the years. With the need for a larger courthouse and the need for a postal facility in this location, we are working with the General Services Administration (GSA) to plan a two-building courthouse complex incorporating the existing federal courthouse site and the General Post Office. We hope to sell the General Post Office to the GSA while retaining a lease on 82,000 square feet of the renovated building. Plans call for the GSA to renovate the entire building, restoring public areas to their 1885 grandeur, including reinstating a four-story glass atrium lobby. Our space would include upgraded building systems, public accessibility, contemporary retail finishes and improved employee working conditions.

In Ft. Worth, Texas, we recently granted an easement that will enable the use of the historic Texas and Pacific railroad station as part of the new light rail commuter line. This station will not only serve as an important terminal for the new commuter line, it will also be restored to its original grandeur and will function as a center of the revitalization of this area of Ft. Worth. We are also reconstructing the post office in this area as part of the revitalization efforts. And in Seattle, Washington, we have offered to sell a now unused postal facility to the local school district so that they can consolidate 20 scattered offices around the city into a centralized location. Local school officials estimate that this arrangement could save the district over \$30 million in acquisition costs.

TURNING RESEARCH AND DEVELOPMENT INTO REALITY

As a general policy, we do not conduct research and development in the same way that other companies do. Normally, our suppliers conduct the necessary research and development of new products, and we test what they have developed. Most of what we call research and development consists of testing the new products and technologies, as well as any modifications to existing products and technology, that our suppliers have developed. However, we do conduct research and development in the field of optical character recognition simply because this technology is so essential for us, and we are the leader in the field.

Our Remote Barcoding System is specifically designed to barcode mail that is not already bar-coded and which existing Optical Character Reading equipment cannot barcode. Multiline

**15 billion
handwritten
addresses**

Our clerks or our new technology read your handwriting, no matter how "creative" it might be.



Pedestal-style robots automate the sorting and loading of mail trays.

Optical Character Readers and Facer Cancelers provide video images of letter mail addresses. These images are first processed by a Remote Computer Reader which attempts to electronically read the image and determine the proper barcode for the delivery point. If the Remote Computer Reader cannot read the address, it transmits the address to a Remote Encoding Center where a worker keys the address by hand.

For years, we have worked to improve the technology we use to recognize handwritten addresses. While the technology we use to electronically read typed or printed addresses has been very successful, we have had only limited success in recognizing handwritten addresses because there is such variation in styles of handwriting. Less than three years ago, Remote Computer Readers (RCR) could fully resolve only 2 percent of the handwritten mail they received. We have improved this technology so that today the RCR can barcode 25 percent of the hand-addressed images it receives.

HANDWRITING RECOGNITION SOFTWARE

In 1998, we awarded a contract for new software that is designed to increase to 50 percent the rate at which the RCR can read and resolve handwritten

addresses. Our goal is to have the new software developed by June 1999 so that it can be deployed to the 254 RCRs we have in place. This new technology reduces the amount of time workers spend keying information by hand at our Remote Encoding Centers. In addition, with improved recognition by the Remote Computer Reader, we can barcode and process more mail faster, resulting in improved service to our customers.



Our automated systems process address changes for the 17 percent of the nation's population that moves each year.



"The Postal Service is committed to providing our customers with real-time information about their mail. This same information, some of which already exists in the mail stream and some of which must be created, when combined with activity-based cost data, will be used to improve services and cost performance for our customers."

Norman E. Lorentz
Senior Vice President and
Chief Technology Officer

NEW IDENTIFICATION CODE SORTING PROGRAM

This year we completed the research and development for two extremely important advances in mail processing technology, and we will begin deploying this new technology in 1999. The first program will upgrade our letter mail automation system so that we will have the ability to sort and track mail. The second program will use the data from this upgraded system to provide valuable management information.

Did you notice the fluorescent barcode on the back of the letters you receive? We use that fluorescent barcode as an identification tag to keep track of the letter while we are trying to determine where it is going. If our machines can read the address or the barcode already on the letter, we can send it on its way in seconds. If our machines cannot immediately read the address or barcode, or the barcode is incorrect, the letter is temporarily staged for further processing. Then either our Remote Computer Readers (RCR) or a Remote Encoding (RC) operator views a video image of the address and applies the correct barcode. Then we use that fluorescent identification barcode to retrieve the letter from the staging area, apply the address barcode and send it on its way.

Our new Identification Code Sorting (ICS) program sends the identification barcode to a computer. After the RCR or RC operator reads the address, the correct address is sent to the computer so all it has to do is simply look up the correct barcode. In addition, every time we

process that letter we update the computer so the computer knows the location of that letter in the mail system. This saves us from having to manually process over 800 million pieces of mail. For example, when you mail a letter in Cody, Wyoming, bound for Chicago, we put a fluorescent identification barcode on the back of the letter and tell the computer the Chicago address. If our machines in Chicago cannot read the address barcode when the letter gets to Chicago, they can simply look up the identification barcode and keep it moving. Right now we cannot read about 6 percent of the address barcodes on the mail, so this increase in efficiency directly improves our customer service. Second, we will no longer have to label and re-barcode over 1.6 billion pieces of mail. This will save us over \$90 million annually.

NATIONAL SERVICE CENTERS

In order to serve our customers better, we are investing in a network of National Service Centers. We opened our second Center in 1998. Located in Kansas City, the Center will serve customers in a 13-state area. When completed, we will have a network of six fully integrated Centers that offer customers easy access to our services and products 24 hours a day, seven days a week via a single toll-free number. The centers are staffed with trained personnel who can answer the approximately 200 million telephone calls that are currently handled by local post offices. These centers offer our customers quick and easy access to the information they need to make better use of all the services we offer.

CODY, WY TO CHICAGO—HOW OUR NEW AUTOMATED SYSTEM WILL WORK

